ESO 1028

ADVANTAGES AND LIMITATIONS OF USING TRADITIONAL METHODS TO PROVIDE LOCAL PUBLIC SERVICES IN A NEW FEDERALISM ERA

by

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July, 1983

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Invited paper presented at the summer meetings of the American Agricultural Economics Association, Purdue University, July 31 through August 3, 1983.

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Fiscal Federalism is the use of multiple levels of government to provide (finance and produce or have produced) those goods and services which citizens desire be provided by government or collective enterprises. In the United States the multiple levels of government consist of the federal government, state governments, local governments (county, municipal, township and school) and in some cases regional governments or special districts. Throughout the history of the United States, the role of these various governmental units has varied. In the early days of the United States, state government was probably the most powerful politically. In terms of public revenues and expenditures from own funds, state-local government revenue and expenditures far exceeded federal revenues and expenditures until the depression years of the 1930s (ACIR, 1980, pp. 4, 55, 64). The advent of the federal income tax in 1913 provided the revenue base for rapid expansion of federal expenditures beginning in the 1930s (Break, p. 44).

For the purposes of this paper, I will focus on four periods: (1) Pre-Depression (before 1929), (2) New Deal and Post World War II recovery (1929-1960), (3) the Great Society (1960-1975) and (4) the New Federalism Era (1975 - ?). In characterizing these periods and in setting the dates for each, I recognize that many of the necessary facilitating policies of each period were implemented during earlier periods. For example, financing of the New Deal legislation probably would not have been possible without the income tax, which was implemented about 20 years earlier. Most forms of intergovernmental revenue transfer programs (general revenue sharing, categorical grants) can be traced far back into the 1800s.

The Pre-Depression period is one of minimal federal government involvement. The federal government was responsible for financing and fighting wars, and for some domestic functions, but was highly subject to the political and often the financial powers of the states.

The depth of the Great Depression provided a vacuum of potential governmental involvement into which the federal government made first entry, an entry made possible by earlier enactment of the income tax. Beginning with emergency relief programs, the stage was set for the enactment of new long-term federal programs such as Social Security, agricultural price supports, and various forms of intergovernmental revenue transfer programs from the federal to state-local governments.

The Great Society era was one which saw the implementation of many additional social programs. The New Deal might be characterized as a "we must do something" era, while in contrast the Great Society era can, I think, be accurately characterized as a "we can do anything" era. In this era came enhanced enforcement of school desegregation, a focus on equity programs, and many national policies which imposed standards on services provided by local communities.

By the mid-1970s, the reality of economic scarcity had reasserted itself, and a series of emerging private economic constraints (for example, energy prices) and fiscal constraints (high tax rates) began to work through the economic system. In the Ford administration, there was a move to apply increasing block grant consolidations (Break, p. 54). A major thrust of the Carter administration was to begin to dismantle and/or reorganize parts of the regulatory structure that emerged over the previous 40 years. With the Reagan administration has come major across the board cuts in federal domestic programs.

In this paper I will examine historical trends in traditional sources of revenue of local governments used to finance local public services in order to determine what can be inferred for the New Federalism Era. The term local is used to mean any public service provided by a local government; it does not refer to the distribution of externalities of various public goods. I include six sources of financing as traditional: (1) private market provision, (2) property taxes, (3) user charges, (4) volunteer efforts, (5) bond financing and (6) intergovernmental revenues. The conceptual model underlying the analysis is a public choice framework where the focus is on understanding why changes have occurred and/or to what forces changes were responding. Although I will not examine the expenditure side of local government finances, I will argue that the current era is a response to excessive federal participation in the financing local government services where the perceived marginal social value of output is less than the marginal social cost of output as measured in part by the federal debt. The use of matching grants to finance services with little spillover is expected to lead to overextension of these services, for example.

At the same time, the socially optimal level of Federal involvement is not at Pre-Depression levels. Many of the programs financed with federal money, at the federal, state, or local level, are perceived as valuable social programs. For example, with the proposed cuts in a variety of environmental programs in the Reagan administration, the concern about underprovision of environmental amenities has increased relative to the concern about overprovision.

In the next section, the role of the six traditional revenue sources in the provision of local public services is examined. In the final section, implications of the analysis for the new era are developed.

Revenue Trends of Traditional Sources of Financing Local Government Services

Six sources of financial revenues for the provision of local services are considered as traditional: (1) private market provision, (2) property taxes, (3) user charges, (4) volunteer effort, (5) bond financing and (6) intergovernmental revenues. These revenue sources are considered to be traditional because they have each been a part of the financial base for local public services, and several for state and federal services, throughout the history of the United States. Other sources of local revenues, such as income and sales taxes, are not considered as traditional because they have in most cases become part of the local revenue system since 1930 and are not at present major sources of local public revenue.

Revenue trends for two of the traditional sources, private market provision and volunteer effort, will not be examined because data series do not exist. Local services such as water, sanitary waste and solid waste have historically been private market services, particularly in rural communities. With the increased number of minimum standards on services and other regulatory constraints, the private market provision of local services has probably declined. While trends cannot be examined directly, it is important that changes in private market provision be considered both in the examination of historical trends and in the prediction of future directions.

Volunteer effort is the second traditional means of financing community services on which data is not available. Hitzhusen suggests that volunteerism is a growing phenomenon. He also suggests that "volunteerism related to community services is predominantly a phenomenon of small rather than large communities." Those services most likely to be provided by volunteers include fire protection, emergency ambulance and libraries. In particular, those concerned about rural community services need to be aware of potential substitution between volunteer effort and direct public revenue financing of services as incentives change.

Three sets of data are examined. First, long-term revenue trends of traditional revenue sources for all local governments are examined. Second revenue trends for each type of local government by revenue source are examined. Finally, revenue trends by size of county are examined.

Presented in Table 1 are long-run trends in local government revenues from property taxes, intergovernmental revenue, charges and miscellaneous (mainly user charges), and general debt (bond financing). Charges and miscellaneous revenues were not found in ACIR data sources, and are from Census of Governments publications only. The other three revenue sources series are a combination of ACIR (1980) and Census of Governments data series. Prior to 1930, the property tax and general debt were the major sources of local public revenues.

During the period 1940-1960, property taxes and intergovernmental revenues increased about 400 percent and general debt about 300 percent while the consumer price index (CPI) doubled. These three revenue sources for which data is available all increased in about the same proportion and all increased in real terms as measured by the CPI. Intergovernmental revenues did approximately triple during the 1930s while property taxes and debt remained unchanged. During the period 1957-1977, property taxes, charges and miscellaneous, and general debt each increased about 400 percent and the CPI doubled, while intergovernmental revenues increased by about 900 percent. In the early 1970s, intergovernmental revenues became the largest source of local

Table 1. Historical Trends in Major Traditional Sources of Local Public Revenues

Year	Property Taxes $ Bil	Property Taxes %[a]	Intergovt. Revenue $ Bil.	Charges & Misc. $ Bil.	General Debt $ Bil.	CPI[c]
1902	0.6	89				
1913	1.2	91				30
1922	3.0	97				50
1929			0.6[b]		14.2	51
1932	4.2	97				41
1939			1.8[b]		16.6	42
1940	4.2	93				42
1949			3.4[b]		16.9	71
1952	8.3	87				80
1957					39.3	84
1959			8.1[b]		47.2	87
1960	15.8	87				89
1962	18.4	88	11.6	5.7	58.8	91
1967	25.2	87	20.2	9.0	81.2	100
1972	40.9	84	39.7	15.8	120.7	125
1977	60.3	81	76.8	27.4	169.5	181
1979	61.7	78	89.1[b]		190.5	217

Source: ACIR, 1980, Tables 1, 2, 58, 123 and U.S. Dept. of Commerce, Census of Governments, Governmental Finances, 1977, Table 52; 1972, Tables 15, 52; 1967, Tables 15, 51; 1962, Tables 15, 51 and 1957, Table 14.

a/ Property taxes as a percent of total local tax collections.

b/ Computed or approximated as local government expenditure after intergovernmental transfers (ACIR, 1980, Table 2) minus local government expenditures from own funds (ACIR, 1980, Table 1).

c/ Consumer Price Index, 1967=100.

government revenues.[1/]

While the Census of Governments designates 93 percent of intergovernmental revenue in 1962 and 78 percent in 1977 as from state government, it appears reasonable to attribute most of the increase in local intergovernmental revenues between 1962 and 1977 to federal increases in intergovernmental transfers. In the 1957-1977 period intergovernmental revenues from the federal government to state and local governments were between 80 and 85 percent of local intergovernmental revenues.

The growing local (and state) government dependence on federal revenues is one among several reasons for the New Federalism Era. One of the major expectations of the New Federalism Era is a reduction of intergovernmental revenues. On an historic basis, if intergovernmental revenues in 1977 had been maintained at their post 1940 relative share of revenue, 1977 intergovernmental revenues would have been about $35-40 billion (or about 50 percent of actual intergovernmental revenues in 1977). If there were no increases in other sources of revenue, this change would have resulted in a decrease of about 20 percent in total local government revenues.

Presented in Table 2 are Total General Revenues and the percent of general revenues contributed by each traditional revenue source plus general debt by unit of local government for the Census of Government years. School districts are the most highly dependent on intergovernmental revenues, followed by county governments when measured as a percent of total revenues. However, municipalities and special

Table 2. Distribution of Traditional Sources of Local Government Revenue by Type of Local Government

Year	Total General Revenue $ Bil.	Percent Distribution to Revenue Sources: Intergovt. Revenues	Property Taxes	Charges & Misc.	General Debt $ Bil.
		All Local Governments			
1977	177.0	42.8	34.0	15.3	169.5
1972	104.2	37.6	39.8	15.1	120.7
1967	57.8	34.7	43.4	15.5	81.2
1962	38.1	30.4	48.2	14.9	58.8
1957	25.2	29.8	48.9	14.1	39.3
		Municipalities			
1977	59.1	39.4	26.2	17.7	71.8
1972	34.0	32.7	31.7	18.8	52.6
1967	18.8	26.2	38.5	19.4	35.3
1962	12.8	20.2	44.7	19.4	26.9
1957	9.1	18.9	46.7	17.7	19.1
		Counties			
1977	41.6	45.1	31.3	16.5	22.7
1972	23.7	42.1	36.5	15.3	14.0
1967	12.5	40.3	42.1	14.0	7.9
1962	8.5	38.6	45.7	12.5	5.4
1957	5.6	38.0	46.5	12.3	3.5

Table 2 continued

Year	Total General Revenue $ Bil.	Percent Distribution to Revenue Sources: Intergovt. Revenues	Property Taxes	Charges & Misc.	General Debt $ Bil.
		Townships			
1977	6.5	29.7	56.8	8.3	4.1
1972	4.0	22.0	64.9	8.5	3.9
1967	2.2	24.5	61.8	8.9	1.9
1962	1.6	22.5	65.3	7.5	1.4
1957	1.1	24.8	63.6	7.2	1.0
		School Districts			
1977	62.8	50.2	42.1	6.6	28.4
1972	39.2	45.0	47.3	6.8	25.3
1967	22.7	44.3	46.9	8.0	18.9
1962	14.1	40.8	51.0	7.4	13.9
1957	8.9	42.1	50.1	7.1	9.1
		Special Districts			
1977	10.9	38.2	14.0	46.5	42.5
1972	5.2	29.6	17.3	52.2	25.0
1967	2.7	23.2	21.5	55.3	17.2
1962	1.8	21.1	25.0	53.9	11.2
1957	1.0	14.1	29.1	56.8	6.6

Source: ACIR, 1980, Table 56 and U.S. Department of Commerce, <u>Census of Governments, Governmental Finances</u>, 1977, Table 49, 1972, Table 15, 1967, Table 15, 1962, Table 15 and 1957, Table 15.

districts have experienced the most rapid growth in dependence on intergovernmental revenues. At the same time, municipalities and special districts have experienced the greatest decline in property tax revenues as a percent of total revenues.

The two units of government which have shown relatively large changes in user charges are county where user charges have increased and special districts where they have decreased. These two units of government have also shown the highest rate of increase in total debt, with a rate of growth about 50 percent above the rates for other local governments. If intergovernmental revenues are reduced significantly in the New Federalism Era, it appears that special districts are the most vulnerable, followed by municipalities. Special districts are more likely to experience financial difficulties because of a high debt to revenue ratio and they are probably more vulnerable to decreases in intergovernmental revenue because they are making relatively new or nontraditional uses of these revenues.

Per capita local government revenues by county population size groups are shown in Table 3 for the Census of Governments years for which the data is available. Per capita general revenues for the two smaller sized groups are 60-75 percent of per capita revenues for the large population counties. The large counties have shown the largest relative rate of decline in property tax revenues and the largest relative rate of increase in intergovernmental revenues between 1962 and 1977. At the same time, the largest county group still derives the

Table 3. Per Capita Local Government Revenue, by Population Size Group of County Areas

	Over 250,000		50,000 to 249,999		Less than 50,000	
	$ Per Capita	% of Gen. Rev.	$ Per Capita	% of Gen. Rev.	$ Per Capita	% of Gen. Rev.
			General Revenue			
1977	998	100	699	100	616	100
1972	615	100	431	100	380	100
1967	348	100	253	100	233	100
1962	252	100	187	100	186	100
			Property Tax			
1977	350	35	225	32	184	30
1972	251	41	167	39	134	35
1967	157	45	105	42	90	38
1962	128	51	86	46	79	42
			Intergovernmental Revenue			
1977	412	41	311	44	292	47
1972	221	36	169	39	163	43
1967	110	32	95	38	98	42
1962	65	26	63	34	74	40
			Charges and Miscellaneous			
1977	137	14	122	17	114	18
1972	85	14	71	17	69	18
1967	51	15	41	16	39	17
1962	37	15	29	15	28	15
			General Debt[a]			
1977	777	78	501	72	380	62
1972	609	99	387	90	293	77
1967	421	121	269	106	187	80
1962	343	136	214	115	159	85

Table 3 continued

	Over 250,000		50,000 to 249,999		Less than 50,000	
	$ Per Capita	% of Gen. Rev.	$ Per Capita	% of Gen. Rev.	$ Per Capita	% of Gen. Rev.
			Number of Counties			
1977	156		563		2402	
1972	146		530		2442	
1967	139		529		2446	
1962	123		469		2532	

Source: U.S. Dept. of Commerce, Census of Governments, Governmental Finances, 1977, Table 52; 1972, Table 51, 1967, Table 51; and 1962, Table 51.

a/ The percent column for general debt is the ratio of debt to general revenue.

largest percent of general revenues from property taxes and receives the smallest percent of revenues from intergovernmental revenues. The smaller or more rural counties have shown the least relative change in revenue sources. The larger more urbanized counties are probably more vulnerable to intergovernmental revenue decreases, if they occur, simply because of the recency of the change. This conclusion is similar to the conclusion for municipalities drawn from Table 2 where large municipalities dominate the data.

With respect to user charges, the two lower population groups of counties have increased dependence on user charges while the large counties have decreased use. All groups of counties show large reductions in debt to revenue ratios over the 15 year period. Even with reductions of 20 to 30 percent in intergovernmental revenues, debt to revenue ratios for each group of counties are still less than their 1972 values. Based on historic trends, local governments can increase debt financing to offset expected losses in intergovernmental revenues, but it will probably require reductions in long-term interest rates before this will occur. Large counties (Table 3) or municipalities (Table 2) have the greatest capacity to increase debt based on historic trends because they have had the lowest growth rates in debt, or the largest relative declines in debt to revenue ratios.

Implications

A major conclusion from this brief analysis is that large amounts of debt have been shifted from the local to the federal level during the past 20 years. While much of the conventional wisdom talks about substitution of the federal income tax for the local property tax, the most striking trend to emerge over the past 20 years from the data as presented here is the substitution of intergovernmental revenues for local debt. Since the federal income tax is not preventing an increase in federal debt, the conclusion that part of the growing federal deficit has been due to increased federal financing of local services is consistent with the data. This conclusion is also consistent with the growing emphasis on block grants and general revenue sharing, and the decrease in emphasis on matching grants, beginning with the Ford administration as an attempt to reduce the growth of federal debt.

This conclusion reveals an important impact of inflation on local government finance. Why did U.S. citizens choose to finance local services from federal debt rather than local debt? I suggest that the cost of financing services from local debt is born immediately through higher interest rates due to inflation. The impact of the cost can be delayed, and perhaps imposed on someone else, if financed from federal sources. There may also be some illusion that the federal income tax can raise sufficient revenue to finance local services. This is at the same time that local taxes are too high and to increase them to substitute current tax revenues for debt (deferred tax revenues) is not viewed as tenable. At some point in time, deferred financing arrangements must be repaid, in this case by a growing federal deficit, and economic constraints are imposed.

The major implication of this analysis is that the traditional revenue sources are still playing their traditional roles in the financing of local community services. Intergovernmental revenues grew disporportionately during the 1960-77 period, and this is currently being reversed by federal budget policy. Hopefully, there will not be an overreaction. Whether local governments can expand their debt to offset reductions in intergovernmental revenues will depend on long-run interest rates. The use of volunteer effort and private market mechanisms to finance services may also be enhanced, particularly in smaller communities.

While there may be some advantages in diversification of revenue sources at the local level, the property tax, user charges, and bonds are likely to continue as major generators of local revenue. While many units of local government now have income or payroll taxes and/or sales taxes, the ability to generate large sums of revenue from these taxes is limited by their use at the federal and state levels and by how much revenue local governments can "coax" away from federal and state governments with these taxes without reducing intergovernmental revenues. It is as likely that local governments will "coax" revenue away from their own property tax through increased use of sales or income taxes. In sum, property taxes, user charges, and bonds are financial tools familiar to local government policy makers and there is no free lunch.

Footnotes

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The author retains sole responsibility for the views expressed in this paper. Helpful comments were received from George Morse, Fred Stocker, Cameron Thraen and other participants of the Economic Development Forum.

1. In comparison to other revenue sources, sales and income taxes both grew more rapidly over these periods, beginning from very small bases in 1940. Sales and income taxes provided 3.3 percent of local tax collections in 1940 and 16 percent in 1977.

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